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CENTRAL INTELLIGENCE AGENCY
OFFICE OF NATIONAL ESTIMATES

24 September 1957

STAFF MEMORANDUM NO. 46-57

SUBJECT: International Financial Disequilibrium in the West

Introduction

1. During the past year the problem of balance among the currencies of the principal Western countries has become of increasing concern. Sharp increases in US and West German foreign exchange earnings have been paralleled by deficits in French and British gold and dollar reserves. Many fear that the underlying disequilibrium may adversely affect Western unity and lead to unfavorable repercussions in one or more of the countries concerned.

2. The meeting of the International Monetary Fund this week focuses special attention on this problem. The Fund is not likely to make any major decisions, however, since the

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positions of the individual Western countries are, for the present at least, fairly fixed. Important decisions affecting this disequilibrium have already been made, i. e. partial devaluation of the franc and adjustments in the bank rates in West Germany and the UK. The members are more likely to use the meetings as an occasion to try to convince the world, and each other, of the soundness of the policies they are currently pursuing.

Reversal in the US Balance of Payments

3. Hugh Gaitskell in a recent speech has called attention to the reemergence of the dollar gap as potentially the most serious problem facing the West, a problem "potentially more serious than events in Syria or the Middle East." Mr. Gaitskell reflects the concern of leading British circles with the fact that during the six months following September 1956 there was a reversal in the flow of gold and dollars in the over-all US balance of payments. For eight years prior to the fall of 1956, gold and dollars had been flowing from the US to strengthen the reserve positions of other countries. Western European countries increased their reserves by \$7.5 billion.

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Underlying this movement of gold and dollars was the fact that about 90 percent of US exports were compensated by imports and that the differential was more than made up by the outward flow of US foreign investment and economic and defense assistance.

4. However, in the six months following September 1956, the US gained \$750 million in gold and dollars on its balance of payments. In order to assist certain countries in meeting their foreign exchange problems the IMF provided \$800 million in dollar credits. The shift in the US balance of payments position was primarily due to an increase in exports while imports declined slightly. (A part of the shift was due to an inflow of capital.) Some change in the US balance was to be expected with expanded exports of oil during the Suez crisis, and unusually high exports of wheat and cotton. Perhaps half of the increase in US exports can be accounted for by these commodity movements. The remaining increase in the US balance of payments is related to the slackening of economic activity in the US relative to the pace of economic activity in the rest of the world, particularly in Western

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Europe*

5. Pauses or recessions in the US which may be relatively mild in their effect on US employment or GNP tend to reduce US imports to a much greater degree. More simply, it has been said that when the US sneezes, Europe catches a cold. Particularly vulnerable to these fluctuations in the level of US activity is the position of sterling. The US recession in 1948-49 led to the devaluation of the pound, although from the British viewpoint the underlying trading position of the sterling area was good (as, in fact, it is today). A temporary decline in US economic activity need not have serious effects in Western Europe. This is more likely to be true when the trend of economic activity in Western Europe offsets a downward trend in the US, and when the balance of payments of other countries with the US has been unusually favorable. Such was

* In the second quarter of 1957 the dollar gap temporarily disappeared and there was a small net outflow of dollars from the US. Without special non-recurring payments, including \$300 million to Venezuela for oil exploration rights, foreign countries would have lost \$400 million to the US.

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the case during the US recession of 1953-54. Expanding markets in Western Europe in part offset the decline in US imports. At the same time there was a decline in the outflow of US gold and dollars but the flow was not reversed.

6. What the British fear is that the current pause in US economic growth will lead to a recession on the scale of 1948 and 1953 against a background of economic developments in Western Europe which will greatly intensify its effect. As noted above, the US balance of payments has already turned adverse (from the Western European standpoint) and the rate of growth in Western Europe, far from accelerating as in 1953, is probably slowing down.

Role of West Germany

7. While the position of the US is of outstanding importance, since its economy accounts for 50 percent of the economic activity of the non-Communist world, the role of West Germany is pertinent to the situation in Western Europe. With the recovery of economic strength it was to be expected that West Germany would reestablish its normal position as a surplus exporter in Western Europe. West German export surpluses have

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historically been compensated through the mechanism of net clearances involving imports from and service payments to sterling area countries. This structure of Western European payments has been largely revived in the operation of the European Payments Union where sterling is freely convertible into gold and dollars. However, the vigor of the West German trade drive and the size of its export earnings has placed strains on the currencies of other countries and particularly of sterling.

8. West German fiscal and monetary policy has operated in such a way as to maximize foreign exchange earnings. Beginning in 1956 West Germany applied brakes on the domestic expansion of its economy. The growth in investment, consumption and government expenditures was dampened down severely. The success of the West German deflationary policy in restraining internal demand has been unparalleled. Currently the expansionary force in the West German economy arises almost entirely from its export surpluses; without these the economy would be stationary. The result was to slow the pace of imports and to maximize exports, since West German exports have benefitted

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from expanding economic activity in the rest of Western Europe. Gold and dollar balances have been piling up in West Germany's favor, reaching a level of about \$3½ billion.

Situation in France

9. Several of the Western European countries, notably France, declined to follow the West German lead in braking their rate of economic advance. The French have regarded a high level of investment and substantial expansion of industrial capacity as essential to strengthening their future economic position and export capacity. However, in the face of deflationary policies in other countries, the trend of French exports in relation to imports was certain to become adverse. The French are still attempting to avoid too severely dampening economic activity by a somewhat selective devaluation and by comparatively mild deflationary measures. Even these measures may prove beyond the political strength of the French government. Since the French trade deficits have a direct counterpart in German export surpluses, there is strong economic pressure for Franco-German cooperation. West Germany is in a position to help France and it is greatly in the West German interest to do so, both on economic and political grounds.

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The Overall Situation as Viewed from London

10. In the interest of balancing its external payments, the UK has maintained deflationary checks on its economy for the past two years. British industrial production was stationary in 1956 and has been expanding slowly during 1957. The British balance of trade has been maintained in surplus throughout the period. However, the UK's principal export markets in non-European countries have not been growing as rapidly as West German markets in Western Europe. Further, the West Germans are providing increasing competition in non-European markets which were formerly an exclusive British preserve. Consequently, British net earnings are not as adequate as they once were to compensate for payments clearings in Western Europe.*

* A potentially underlying weakness in the British position has been the inability of the UK to restrain wages in line with restraints on industrial activity and prices. Since January 1956, British prices have advanced 5 percent while wages advanced 10 percent. This is a weakness in times of restrained economic activity, which the UK currently shares with the US. From the British standpoint, this potential weakness is most easily dealt with through further economic growth. The necessity for external balance requires, however, that this growth take place in phase with growth in the US and other countries.

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11. The disparities in the foreign payments positions of the major Western European countries, reflecting disparities in fiscal and monetary policies, has been accentuated by speculative capital movements to both the dollar and the mark. The pound, already under some pressure as a convertible link between continental currencies and the dollar, is particularly vulnerable to this speculation. Its vulnerability was increased by the weakening of reserves following the Suez crisis. Since the British have already exercised a large measure of deflationary restraints on the British economy, they do not believe that the pound is overvalued. However, the pound could prove to be overvalued in terms of the sterling area reserves required to sustain the confidence of speculators. The greater the disparities between the fiscal policies of major countries, the greater the sterling area reserves required to sustain confidence.

12. According to traditional international financial precedent, what the British like to call "the rules of the game," countries in substantial surplus on international account should relax credit restraints at home. The West Germans have refused to play, and the British may believe that the West Germans are

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seeking devaluation of the pound. The West Germans have maintained stringent credit restrictions and have carefully insulated the West German economy from the effects of their large foreign exchange earnings. The relatively high West German bank rate has helped to encourage speculation against both the franc and the pound, thus accentuating imbalance, i.e. reinforcing rather than compensating the trade imbalances.

13. The recent lowering of the West German bank rate by 1/2 percent from 4 1/2 to 4, must be accepted as a failure of British influence and representations to Bonn. The adjustment, while in the right direction was too small to be of assistance to the UK. It was an adjustment probably dictated entirely by West German interest. As the size of the West German export surplus declines, as it must if only in response to a slackening of French imports, the level of West German economic activity is in danger of turning downward. Hence a mild expansion of credit in West Germany is in order.

14. British officials probably believe that trends leading to a scaling down of West German trade surpluses are already operating. There may be a disquiet in London that the net effect of the West German position may be a slackening of even turning

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down of economic activity in Western Europe. The British probably recognize that they are in no position to influence this trend. The more immediate concern of British officials is with speculation against the pound. They may estimate that within the context of the West European situation, the pound can be defended against speculation. However, if a US recession is in the offing--and the British may estimate this chance as at least even--then the pressure against sterling will almost certainly become overwhelming. It was against the background of these uncertainties that the UK bank rate was raised from 5 to 7 percent. Equally significant is the decision to hold the line against "all" increases in government expenditures and to impose credit restraints which appear likely to enforce a stern deflation in the British economy.

Probable Future Developments

15. Since the US economy includes such a large part of the economic activities of the non-Communist world, future developments in this field depend to singularly high degree on the course of events and policies in the US. It would be easy to conjure up dire economic and political consequences of a

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recession in the US. However, US policy makers are highly sensitive to early trends in this direction. Let us assume for estimative purposes a recession on the scale of 1948-or 1953. (Each of these recessions ran their course over a period of 18 months and involved a 7 percent average fall in US industrial production and a one percent drop in GNP.)

16. A similar fluctuation in the US economy over the next year or two would probably be paralleled by a mild recession spreading throughout Western Europe. In this event the Western European countries would attempt to establish the closest cooperation with the US. They would both collectively and individually seek to obtain US support for reestablishing discriminatory regulations against the dollar. They would almost certainly seek dollar credits. Cooperation among sterling area and Western European countries would be enhanced, but efforts to form an insulated grouping of non-dollar countries would almost certainly be frustrated. The UK and West Germany now share almost equal weight in the financial leadership of the non-dollar free world. The diverse pull of their respective interests appears likely to prevent the emergence of a cohesive non-dollar grouping, at least in Western Europe.

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17. West Germany would be likely to emerge from such a temporary recession in an even stronger position in Western Europe. In any case Franco-German ties are almost certain to become closer. On the other hand the UK's position under the assumed circumstances seems likely to become weaker. It may be forced helter-skelter into a major devaluation which would further weaken the sterling area and impede the growth of living standards in the UK. This would be particularly the case in the three to five years following a major devaluation. There may be further retrenchments or significant delays in the British defense program.

18. On the assumption that the present pause in US economic growth is followed by a gradual acceleration in the rate of growth to levels sustained during the past few years, the position of Western Europe is likely to remain relatively unchanged. If the UK is able to undertake a more severe deflation, it may emerge in a strengthened international position. This would be achieved at some cost in industrial and political strife. A strengthening of sterling would enhance the prospects for British leadership in Western Europe. In a real sense the British and

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West Germans are contending for leadership in Western Europe through international financial means. The British government appears to be aware of the challenge.

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